Nebraska Law Review

Volume 71 | Issue 4 Article 5

1992

Pointing the Way through Section 461(g): The Deductibility of Points Paid in Connection with the Acquisition or Improvement of a Principal Residence

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I. INTRODUCTION

The ability of individuals to deduct interest for Federal income tax purposes has been sharply limited since the passage of the Tax Reform Act of 1986. One category of interest that remains deductible under present law consists of "qualified residence interest." Very generally, this category includes interest on indebtedness that is secured by a qualified residence of the taxpayer. It may be thought of generically as interest on home mortgage indebtedness. Qualified residence interest has been of heightened significance for many individual taxpayers since the enactment of the Tax Reform Act of 1986 because it is virtually the only type of interest that is deductible even though unrelated to a trade, business or investment activity.

In obtaining a loan, particularly a home mortgage loan, a borrower may be required not only to pay a stated rate of interest over the term of the loan, but also to pay one or more "points" at the time the loan proceeds are advanced. Such points are usually expressed as a percentage of the loan amount (*i.e.*, one "point" equals one percent of the loan amount) and constitute a form of prepaid interest. Generally, they are charged by a lender at the time of making a loan in exchange for a lower stated rate of interest over the term of the loan. Because they represent compensation for the use or forbearance of money, points paid or incurred in obtaining a loan are generally considered interest and, like the interest charged during the term of the loan itself, may be qualified residence interest.

Although points may constitute qualified residence interest, their deductibility may be subject to limitations imposed by Internal Revenue Code section 461(g), enacted by the Tax Reform Act of 1976. Section 461(g) defers a cash method taxpayer's deduction for prepaid interest to the period to which such payment is properly allocable. Therefore, if an item constitutes qualified residence interest, but is also prepaid interest, the otherwise allowable deduction may be deferred. This deferral rule does not apply, however, to certain "points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the taxpayer's principal residence."

Just as the category of qualified residence interest has assumed heightened significance for individual taxpayers under post-1986 law, so too has the question of how points paid in connection with a home mortgage loan will be treated for Federal income tax purposes. The latter question, which is the subject of this article, has become even more critical because of the confluence of several recent events. First, the relatively low interest rates recently prevailing have prompted an increase in home mortgage financings and refinancings and, with that phenomenon, an increase in the number of individual taxpayers who have recently paid or will pay points in that context. Second, section 461(g) has been the subject of recent case law and administrative developments that have added a degree of uncertainty and confusion concerning the scope of that provision as it affects individual taxpayers.

This Article seeks to illustrate and clarify the law in this area by examining the limitations on the ability of individual taxpayers to deduct prepaid interest under section 461(g), with an emphasis on points relating to the acquisition or improvement of a principal residence. First, it outlines the relevant statutory provisions concerning the deduction for interest paid by individuals and the limitations imposed on the deduction of prepaid interest under section 461(g). In particular, it examines the circumstances surrounding Congress' enactment of section 461(g). Second, this Article considers the relevant case law and administrative pronouncements defining the scope of the provision, especially section 461(g)(2), as it affects individuals. In this context, it notes that Congress could alleviate some confusion in this area by amending section 461(g)(2) to conform more closely with section 163(h), insofar as interest or points relate to indebtedness incurred to acquire, construct, or substantially improve a principal residence. Finally, this Article analyzes the Internal Revenue Service's recently articulated position in Revenue Procedure 92-12, which creates a safe harbor for the deduction of points paid in connection with the acquisition of a principal residence. The Article concludes that the elements defining this safe harbor are largely consistent with prior authorities, yet contain several ambiguities that may undermine the predictability, and hence usefulness, of the Internal Revenue Service's "safe harbor" test. It argues that such ambiguities should be resolved in a manner consistent with existing law. Moreover, it emphasizes that the safe harbor itself is not exclusive, and identifies those situations in which prepaid interest, not meeting the requirements of the safe harbor, remains deductible.

II. STATUTORY PROVISIONS GOVERNING THE DEDUCTIBILITY OF QUALIFIED RESIDENCE INTEREST AND PREPAID INTEREST

A. Section 163(h)

Present law sharply limits the ability of individuals to deduct "personal interest" for Federal income tax purposes. In contrast with pre-1986 law, which permitted a deduction for interest on indebtedness generally, including that incurred to finance wholly personal expenditures, current law treats interest paid by individuals as non-deductible personal interest unless it falls within any of five specifically enumerated categories.[1] Of significance for many individual taxpayers, deductible interest under post-1986 law includes "qualified residence interest."[2] This category includes interest on certain "acquisition indebtedness," which is secured by a qualified residence of the taxpayer and which is incurred in acquiring, constructing, or substantially improving such a residence, or in refinancing certain indebtedness that was so incurred.[3] It also includes interest on certain "home equity" indebtedness, which is secured by a qualified residence of the taxpayer, without regard to the purpose for which the loan is incurred.[4]

1. Individual taxpayers may not deduct "personal interest." I.R.C. § 163(h)(1)(1988). "Personal interest" means any interest other than: (A) trade or business related interest; (B) investment interest; (C) interest allocable to any passive activity; (D) qualified residence interest; and (E) certain interest paid in connection with estate tax liabilities. I.R.C. § 163(h)(2)(1988). Except as otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended and presently in effect.
2. "Qualified residence interest" means any interest paid or accrued on "acquisition indebtedness" (as defined in I.R.C. § 163(h)(3)(B)(1988)) or "home equity indebtedness" (as defined in I.R.C. § 163(h)(3)(C)(1988)). In order to qualify under either category, the indebtedness must be secured by a "qualified residence." I.R.C. §§ 163(h)(3)(B)(i)(II)(1988), (C)(i)(1988). The term "qualified residence" is defined to mean the taxpayer's principal residence (within the meaning of I.R.C. § 1034(1988)) and one other residence of the taxpayer designated for this purpose and used as a residence (within the meaning of I.R.C. § 280A(d)(1)(1988)). I.R.C. § 163(h)(5)(A)(1988).
3. "Acquisition indebtedness" means indebtedness used to acquire, construct or substantially improve a qualified residence and includes indebtedness used to refinance indebtedness used for the foregoing purposes, up to the amount of the refinanced indebtedness. The aggregate amount qualifying as acquisition indebtedness in any taxable period is limited to $1,000,000. I.R.C. § 163(h)(3)(B)(1988).
4. "Home equity indebtedness" is indebtedness secured by a qualified residence and not in excess of (i) the fair market value of the residence, reduced by (ii) the amount of acquisition indebtedness with respect to such residence. The aggregate amount qualifying as home equity indebtedness for any taxable period is limited to $100,000. I.R.C. § 163(h)(3)(C)(1988).

B. Section 461(g)

1. *In General*

Although Congress has permitted individuals to deduct qualified residence interest, it has done so against the backdrop of certain other statutory provisions affecting interest. In particular, I.R.C. section 461(g), enacted by the Tax Reform Act of 1976,[5] places limits on the deductibility of prepaid interest. As a general rule, section 461(g)(1) defers a cash method taxpayer's deduction for prepaid interest to the period to which such payment is properly allocable. Therefore, if an item constitutes qualified residence interest, but is also prepaid interest, the otherwise allowable deduction may be deferred under section 461(g)(1).

One of the most common forms of prepaid interest consists of "points" charged by a lender at the time of making a loan. Such points are usually charged in exchange for providing a lower stated rate of interest over the term of the loan and represent compensation for the use or forbearance of money. Significantly, however, from the perspective of individual taxpayers, section 461(g)(2) provides that the deferral rule of section 461(g)(1) does not apply to certain "points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the taxpayer's principal residence."[6]

2. *Enactment of I.R.C. Section 461(g)*

Prior to the enactment of section 461(g) as part of the Tax Reform Act of 1976, no specific statutory provision addressed the treatment of prepaid interest by a cash method taxpayer. The area thus was gov-

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5. Tax Reform Act of 1976, Pub. L. No. 94-455, § 208(a), 90 Stat. 1542 (1976); I.R.C. § 461(g)(1988) provides as follows:

> (g) PREPAID INTEREST.—
> (1) IN GENERAL.—If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations prescribed by the Secretary, is properly allocable to any period —
> (A) with respect to which the interest represents a charge for the use or forbearance of money, and
> (B) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.
> (2) EXCEPTION.—This subsection shall not apply to points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area.

6. I.R.C. § 461(g)(2)(1988).

erned by case law and administrative rulings. Until the late 1960s, taxpayers were able to prepay as much as five years' interest with the apparent approval of the courts and the Internal Revenue Service.[7]

In 1968, however, the Internal Revenue Service ruled that a cash method taxpayer's deduction for an interest prepayment covering a period ending more than twelve months beyond the close of the taxable year of payment would be deemed to create a material distortion of income. The deduction would, therefore, have to be allocated over the taxable years to which the payment related, rather than be allowed in full in the year of payment.[8] If the interest prepayment covered a period ending less than twelve months beyond the close of the taxable year, various factors would apply in determining whether the payment resulted in a material distortion of income.[9]

In enacting the Tax Reform Act of 1976, Congress was concerned with the phenomenon of "tax shelters," a preoccupation that only became more acute by 1986.[10] With specific reference to section 461(g), the legislative history reflects Congress' concern that prepaid interest was extensively used in many tax shelters "to defer tax on income which would otherwise be taxable in higher marginal brackets" and its belief that the "creation of a tax shelter with prepaid interest cannot be justified even under the cash method of accounting."[11]

Several aspects of the enactment of section 461(g) are noteworthy. For one, the provision sought to conform the tax treatment of interest prepayments by cash method taxpayers with that required of accrual method taxpayers.[12] Moreover, Congress noted the "considerable un-

7. *See* H.R. REP. NO. 658, 94th Cong., 2d Sess., at 97 (1975); S. REP. NO. 938, 94th Cong., 2d Sess. 101 (1976).
8. Rev. Rul. 68-643, 1968-2 C.B. 76.
9. The ruling considered, for example: the amount of the taxpayer's income in the year of payment and in previous years; the amount of the prepaid interest; the time of payment; the reason for the prepayment; and the presence of a varying rate of interest over the term of the loan. *Id.*
10. The House Report's description of the provisions of the bill addressed to tax shelters spans over 100 pages. *See generally* H. R. REP. NO. 658 at 8, 25-130; *See also* S. REP. NO. 938 at 3, 39-108. In response to the problems of "tax shelters," the Tax Reform Act of 1976 also added the "at-risk rules" of I.R.C. § 465 (1988), precluded use of the cash method of accounting for many farming activities, and amended certain partnership provisions. Significantly, however, it did not enact provisions imposing Limitations on Artificial Losses (LAL) proposed by the House version of the bill. In 1986, Congress enacted, among other provisions, the passive activity loss rules of I.R.C. § 469 (1988).
11. Congress indicated that the justifications underlying the use of the cash method, namely, simplicity and avoidance of complex recordkeeping or computations, were inapplicable to prepaid interest, which could be allocated over the term of a loan. H.R. REP. NO. 658 at 99; S. REP. NO. 938 at 103.
12. H.R. REP. NO. 658 at 100; S. REP. NO. 938 at 104. The committee reports noted that an accrual method taxpayer could deduct prepaid interest only in the period in which the use of money occurs and only to the extent of the interest cost of

certainty" inherent in the case-by-case approach of then-existing law as to whether a particular payment resulted in a material distortion of income.[13] Congress did not intend to change the existing definition of "interest;" in order to be deductible under section 461(g), an item would have to constitute interest that was otherwise deductible.[14] Similarly, it did not intend to change then-existing law with respect to a cash method taxpayer who received a "discount loan" in which the lender delivered to the borrower an amount less than the face amount of the loan, with the difference representing a charge for the use of the borrowed funds. Such a taxpayer could not deduct the entire interest element inherent in the discount in the year in which the loan proceeds were received, but rather could deduct the interest element only when and as the face amount of the loan was repaid.[15]

3. *The Section 461(g)(2) Exception*

Notwithstanding the broad rule prohibiting an immediate deduction for prepaid interest under section 461(g)(1), Congress created an exception in section 461(g)(2). Under this exception, points paid by a cash method taxpayer on indebtedness incurred in connection with the purchase or improvement of, and secured by, the taxpayer's principal residence are deductible in the year of actual payment. The committee reports indicate that points will not qualify under this exception "if the loan proceeds were used for purposes other than purchasing or improving the taxpayer's principal residence, or if loan proceeds secured by other property were used to purchase or improve a principal residence."[16] The exception was to apply only to "points on a home mortgage, and not to other charges."[17] The Senate bill added the further requirement, adopted in the House-Senate conference, that in order to qualify under the section 461(g)(2) exception, the charging of points must reflect an established business practice in the geographical area where the loan is made, and the deduction allowed cannot exceed the number of points generally charged in that area for comparable transactions.[18] The House and Senate committee reports

using the borrowed funds during that period. The time of actual payment was not material, nor was the existence of a fixed liability to make a prepayment of interest sufficient to justify a deduction. *Id.* at n.6.

13. H.R. REP. NO. 658 at 99; S. REP. NO. 938 at 103.
14. The legislative history noted that a purported interest payment might not be true interest and indicated that the Internal Revenue Service or taxpayers could still assert, where appropriate, that a payment denominated "interest" was, in substance, an additional portion of the purchase price of property, a dividend, a payment for an option, etc. H.R. REP. NO. 658 at 100, n.7; S. REP. NO. 938 at 104, n.7.
15. H.R. REP. NO. 658 at 101; S. REP. NO. 938 at 105.
16. *See supra* note 15.
17. *See supra* note 15.
18. S. REP. NO. 938 at 105; H.R. CONF. REP. NO. 1515, 94th Cong., 2d Sess. 417 (1976).

were in virtual accord on all issues, except for this "geographical conformity" requirement, which was not addressed in the House Report.[19]

While the legislative history is relatively explicit concerning Congress' reasons for adding section 461(g)(1), it does not elaborate upon its rationale for providing the exception of section 461(g)(2). Nevertheless, one can surmise that given its concern about the use of prepaid interest in "tax shelters," Congress perceived a lesser possibility of abuse in the case of points relating to the purchase or improvement of a taxpayer's principal residence. Furthermore, Congress may also have sought to preserve and codify, at least in part, what it perceived as the existing administrative practice concerning points paid in connection with indebtedness incurred to purchase a personal residence.[20] In any event, the emphasis in the legislative history on the technical elements of the exception and the addition by the Senate of the "geographical conformity" requirement leave one with the overall impression that Congress intended section 461(g)(2) to be a fairly narrow exception to the broad deferral rule of section 461(g)(1).

III. CASE LAW AND ADMINISTRATIVE DEVELOPMENT OF SECTION 461(g)

Since its enactment, section 461(g) has been the subject of case law and administrative rulings. The following section of this article identifies and discusses the problems presented and issues raised by such authorities.

A. Identifying Prepayments that Qualify as Interest

As noted above, section 461(g) was not intended to change the defi-

19. The two bills also contained different transitional rules and effective dates. H.R. REP. NO. 658 at 101; S. REP. NO. 938 at 105. As enacted, § 461(g) generally applies to prepayments of interest made on and after January 1, 1976, with an exception for prepayments of interest made before January 1, 1977, pursuant to a binding contract or written loan commitment in existence on September 16, 1975 (and at all times thereafter), and which required prepayment of such amounts by the taxpayer. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1542 (1976). For a case construing the provisions of this transitional rule, see Wetterholm v. Comm'r, 51 T.C.M. (CCH) 988 (1986), finding that the issuance of a conditional commitment by the Department of Housing and Urban Development (HUD) was not a "written loan commitment" of the type required by the transitional rule, and thus holding that a prepayment of interest made during 1976 was subject to the provisions of § 461(g).

20. In Rev. Rul. 69-582, 1969-2 C.B. 29, a cash method taxpayer paid six "points," constituting interest, from separate funds in connection with a mortgage loan for the purchase of a principal residence. The Internal Revenue Service ruled that such payment did not result in a material distortion of income and was therefore deductible currently without the need for proration as might otherwise be required by Rev. Rul. 68-643, 1968-2 C.B. 76, discussed *supra* note 8 and accompanying text.

nition of "interest."[21] Although the legislative history did not specifically elaborate on that definition, other than to identify certain payments that would not be considered interest,[22] prior authorities had generally held that irrespective of the particular label used to describe it, "interest" for tax purposes represents a "compensation for the use or forbearance of money."[23] Consistent with this approach, it has been held that a payment must be true interest to be both subject to section 461(g)(1) and eligible for the exception thereto under section 461(g)(2).[24] In *Beek v. Commissioner*,[25] the Tax Court held that all interest deductible under section 163 is subject to the allocation provisions of section 461(g). In doing so, it rejected the taxpayer's proposed definition of interest which was based upon state-usury law concepts and under which a so-called "time-price differential" paid in connection with the acquisition of property was not "interest" within the purview of section 461(g)(1).[26]

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21. *See supra* note 14 and accompanying text.
22. *See supra* note 14 (observing that the legislative history indicates that in appropriate cases, a payment denominated as "interest" might be recharacterized as a payment of an additional portion of the purchase price for property, a dividend, or a payment for an option).
23. *See, e.g.*, Deputy v. Dupont, 308 U.S. 488 (1940).
24. For situations arising prior to the effective date of § 461(g), see, for example, Rev. Rul. 69-582, 1969-2 C.B. 29 (payment of six "points" ($1200) from separate funds in connection with a $20,000 mortgage loan used to purchase a $25,000 principal residence was interest because paid as compensation to the lender solely for the use or forbearance of money; *held*: payment was deductible and did not result in a material distortion of income); Cathcart v. Comm'r, 36 T.C.M. (CCH) 1321 (1977)(points charged in connection with a loan incurred during 1973 concededly represented an interest charge, and not a charge for services rendered, but a deduction was denied because points were incurred in connection with a net proceeds loan, and therefore not "paid" during the year of the loan). For a case arising after the effective date of § 461(g), see Fox v. Comm'r, 57 T.C.M. (CCH) 383, *aff'd without published opinion*, 943 F.2d 55 (9th Cir. 1991)(item denominated points may have been a nondeductible charge for services rendered, rather than a true interest charge, but even if the item were true interest, it was not "paid" by the taxpayers, who received a net proceeds loan from the lender).
25. 80 T.C. 1024 (1983).
26. The taxpayers in *Beek* argued that since § 461(g) uses both the term "interest" and the phrase "a charge for the use or forbearance of money," some interest prepayments did not represent a charge for the use or forbearance of money and could therefore be deducted without regard to the limitations of that section. Relying upon the legislative history described *supra* note 14 and accompanying text, the Tax Court rejected that argument and properly concluded that all interest on indebtedness described in § 163 was subject to the allocation rules of § 461(g). It found that Congress had not intended to change the definition of "interest" for tax purposes, and had known that collusive buyers and sellers might designate as interest in their contracts certain payments, such as payments of additional purchase price, that were not true interest. To distinguish between such payments, it used the term "interest" to describe the former and the phrase "a charge for the use or forbearance of money" for the latter. The Tax Court thus concluded that Congress intended to ensure that, irrespective of the labels affixed

B. The Concept of "Payment" and the Problems of Net Proceeds Loans

As indicated earlier, Congress did not intend by the enactment of section 461(g) to change the treatment of a cash method taxpayer who received a "discount loan" (*i.e.*, one in which the lender delivered an amount smaller than the face amount of the loan, with the difference representing a charge for the use of the borrowed funds). Such a taxpayer could not deduct the entire interest element inherent in the discount in the year in which the loan proceeds were received, but rather could deduct it only when and as the face amount of the loan was repaid.[27]

Accordingly, no deduction is permitted under section 461(g)(2) where the points are withheld by the lender as part of a net-proceeds loan made to a cash method taxpayer. In *Schubel v. Commissioner*,[28] the earliest case to so decide, the Tax Court cited two bases for its conclusion. First, it found that when Congress used the term "paid" in section 461(g)(2), it was aware of the existing case law in the specific area of prepaid interest and the narrow interpretation of the term "paid" in general. Second, it concluded that section 461(g)(2) only lifts the bar to the deduction for prepaid interest created by section 461(g)(1); even if that limitation is inapplicable, it still must be demonstrated that a deduction is proper under the taxpayer's method of accounting. In this connection, the incurring of points through a net-proceeds loan was likened to the furnishing of the taxpayer's own promissory note, an act that would not constitute payment by a cash method taxpayer.[29] Other decided cases have reached this result.[30] Furthermore, in those situations in which it has ruled that a deduction was allowable under section 461(g)(2), the Internal Revenue Service has emphasized that the points were paid from separate funds that were brought to the loan closing.[31]

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by the taxpayers, only prepayments that were truly interest for tax purposes were subject to the allocation rules of § 461(g). Beek v. Comm'r, 80 T.C. 1024, 1032-33 (1983).

27. H.R. REP. NO. 658 at 98, 101; S. REP. NO. 938 at 105.
28. 77 T.C. 701 (1981).
29. *Id.* at 706-707. The court relied upon Rubnitz v. Comm'r, 67 T.C. 621 (1977), involving a taxable year prior to the enactment of § 461(g), which held that a cash method partnership did not "pay" points in connection with a loan where the lender withheld such points from the loan proceeds advanced. For another case applying this rule under the law in effect prior to the enactment of § 461(g), see Cathcart v. Comm'r, 36 T.C.M. (CCH) 1321 (1977)(deduction denied where points constituted "true interest", but were withheld by the lender from the loan proceeds).
30. *See, e.g.*, Fox v. Comm'r, 57 T.C.M. (CCH) 383 (1989), *aff'd without published opinion*, 943 F.2d 55 (9th Cir. 1991).
31. *See, e.g.*, Rev. Rul. 87-22, 1987-1 C.B. 146. In Situation 2 described in the ruling, part of the loan proceeds were used for the improvement of the taxpayer's principal residence, and points allocable thereto were held to be deductible under

C. Qualifying Uses of Loan Proceeds: Purchase or Improvement of a Principal Residence

1. *In General*

By requiring that the points be "paid in respect of indebtedness incurred in connection with the purchase or improvement of a principal residence," the statutory language makes clear that the purpose for which the loan proceeds are used is a material element in determining whether the section 461(g)(2) exception is available. The legislative history indicates that points will not qualify under the exception "if the loan proceeds are used for purposes other than purchasing or improving the taxpayer's principal residence, or if loan proceeds secured by property other than his principal residence are used to purchase or improve his residence."[32] In all cases, the statute specifies that the indebtedness must be secured by the taxpayer's principal residence in order for section 461(g)(2) to apply.

2. *Loan Proceeds Used in Connection with the "Purchase" of a Principal Residence and the Related Problems of Refinancing*

Where the loan proceeds for which points are paid are used by the taxpayer to purchase a principal residence (*i.e.*, are obtained and paid over to or for the benefit of the seller of the residence) the use of proceeds requirement imposed by section 461(g)(2) is satisfied. Difficulties arise, however, where the loan proceeds are used to refinance a prior loan that was itself used to effect such a purchase.

In its administrative pronouncements, the Internal Revenue Service had indicated that loan proceeds used to refinance an existing indebtedness ordinarily would not satisfy the requirements of section 461(g)(2).[33] Moreover, the use of loan proceeds to refinance preexisting purchase money indebtedness, rather than to initially purchase a principal residence, had been noted by courts in several cases as a possible ground for finding section 461(g)(2) inapplicable, although no court had expressly used that fact as a basis for its decision.[34] It was

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§ 461(g)(2). The Internal Revenue Service emphasized that the points in question were "paid from separate funds of [the taxpayer] that were brought to the loan closing. If the points had not been paid from separate funds of [the taxpayer] that had been brought to the loan closing, the points would not have been paid at the time of the closing, and it would be irrelevant whether the indebtedness was incurred in connection with the purchase or improvement of [the taxpayer's] principal residence." *Id.* at 147.

32. *See supra* text accompanying note 16.

33. *See* Rev. Rul. 87-22, 1987-1 C.B. 146.

34. In Schubel v. Comm'r, discussed *supra* text accompanying notes 28-29, a deduction was denied because points were not "paid" by taxpayers where they were withheld by the lender as part of a net proceeds loan. The court did not address

not until the case of *Huntsman v. Commissioner* [35] that a court directly addressed the deductibility of points paid in connection with the refinancing of indebtedness that itself was used to purchase a principal residence.

In *Huntsman*, the taxpayers had obtained a $122,000 loan in January 1981. They used the proceeds to purchase their principal residence. This loan was a three-year mortgage financing with a balloon payment due at maturity. In July 1982, they obtained a $22,000 home improvement loan, secured by a second mortgage on their home. Finally, in September 1983, they obtained a $148,000 thirty-year variable rate mortgage secured by their home. They paid three points and used the proceeds to repay the outstanding balance of the prior loans. For their 1983 taxable year, they deducted the three points paid in connection with the last of these loans.

The Commissioner denied the deduction, asserting that section 461(g)(2) did not apply to points paid for refinancing a home mortgage, but rather only to points paid in financing the initial purchase. The Tax Court upheld the Commissioner's determination by a vote of 8-3. The majority of the Tax Court inferred from the legislative history that section 462(g)(2) was limited to points paid in connection with financing the actual purchase of a principal residence or financing improvements to such residence. The majority found it significant that, as part of the Revenue Act of 1987, Congress had amended section 163(h) to specifically address the deductibility of interest generally on certain refinancing loans, but had left section 461(g) unchanged.[36] Re-

the Internal Revenue Service's alternative argument that because the loan proceeds were used to pay existing indebtedness, they were not used for "the purchase or improvement of . . . the principal residence of the taxpayer." *See also* Fox v. Comm'r, 57 T.C.M. (CCH) 383 (1989), *aff'd without published opinion*, 943 F.2d 55 (9th Cir. 1991)(court observed that points may not be deductible to the extent that loan proceeds are used for refinancing, but sustained disallowance of deduction on grounds that points were not "paid" where retained by lender in a net proceeds loan transaction).

35. 91 T.C. 917 (1988), *rev'd*, 905 F.2d 1182 (8th Cir. 1990).

36. Deductible "qualified residence interest" includes interest paid during the taxable year on "acquisition indebtedness with regard to any qualified residence of the taxpayer." I.R.C. § 163(h)(3)(A)(i)(1988). Acquisition indebtedness means any indebtedness which (1) is incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer, and (2) is secured by such residence. Since the enactment of the 1987 amendments referred to (*see* Pub. L. No. 100-203, § 10102(a), 101 Stat. 1330-384 (1987)), it also includes indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence, but only to the extent that the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness. I.R.C. § 163(h)(3)(B)(1988)(flush language). The statute also includes within this definition any indebtedness in a series of refinancings, to the extent that (1) the initial indebtedness in the series was incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer and was secured by such a residence, and (2) the amount of the particular

ferring to the statutory language, the majority emphasized that in a refinancing transaction the funds are ordinarily used not to purchase or improve a principal residence, but rather to repay the loan that is already in existence and thereby lower the interest costs incurred or achieve some other financial goal not connected directly with home ownership. Finally, the majority was unwilling to reach a contrary result merely because the taxpayers, at least in part by their own choosing, had structured the transaction so that they would be liable within three years for the repayment of the entire outstanding balance of the January 1981 loan.

On appeal, the Eighth Circuit reversed, relying largely upon the reasoning of Tax Court Judge Ruwe's dissenting opinion below.[37] Like Judge Ruwe, the Eighth Circuit panel believed that the Tax Court majority had construed too narrowly the phrase "in connection with" contained in section 461(g)(2). It concluded that the quoted phrase required only that the indebtedness have an " 'association' or 'relation' with the purchase of the taxpayer's residence," and emphasized that the statute did not by its terms impose the standard articulated by the Tax Court majority (*i.e.*, that the indebtedness be "directly related to the actual acquisition of the principal residence").[38] The Tax Court considered the initial short-term loan to be merely the first integrated step by which the taxpayers secured financing to purchase their home, a process which was completed when they incurred the permanent, thirty-year loan in September 1983. Hence, the Eighth Circuit concluded that the latter indebtedness was incurred in connection with the purchase or improvement of a principal residence, and that the points paid in connection therewith were therefore deductible under section 461(g)(2).[39] The Eighth Circuit's decision in *Huntsman* thus opened the door to a deduction for points paid in connection with a refinancing of prior indebtedness that was itself used to purchase or improve the taxpayers' principal residence.

The correctness of the Eighth Circuit's decision in *Huntsman* is open to question. Granted, its reading of the statutory phrase "in connection with" is linguistically defensible. Additionally, the pertinent

indebtedness does not exceed the amount of the indebtedness that it refinanced. *Id.* For a discussion of the differences between § 163(h) and § 461(g), *see infra* text accompanying notes 49-55.

37. For a discussion of *Huntsman*, see Mark B. Persellin et al., *Eighth Circuit's Decision in Huntsman Complicates Treatment of Points Incurred in Refinancings*, 15 REV. TAX'N INDIVIDUALS 302 (1991)(discussing Eighth Circuit's opinion). *See also* J. Martin Burke & Michael K. Friel, *The Service Wins on Points: Interpreting Section 461(g)(2)*, 13 REV. TAX'N INDIVIDUALS 276 (1989)(discussing Tax Court's decision in *Huntsman*).

38. Huntsman v. Comm'r, 905 F.2d 1182, 1184 (8th Cir. 1990)(quoting from 91 T.C 917, 921 (1988)).

39. *Id.* at 1185.

legislative history is not explicit on the applicability *vel non* of section 461(g)(2) to the facts presented in the case. Yet, the legislative history does emphasize the specific and technical requirements of the statute, and gives the overall impression that Congress intended section 461(g)(2) as a narrow, rather than expansive, exception to the broad rule of disallowance under section 461(g)(1).[40] Furthermore, by holding that the taxpayers' initial three-year, balloon note financing could be integrated with the later refinancing loan, the Eighth Circuit's opinion leaves open the question of whether an initial loan can have a longer term (*e.g.*, five years or more), yet still be integrated with a later refinancing, such that the latter indebtedness will be deemed "in connection with" the purchase or improvement of the principal residence. This fact creates the possibility that further cases will arise, with resolution of the issue occurring on a case-by-case basis.[41] Although not determinative of the question, the pertinent legislative history does indicate that by enacting section 461(g), Congress was concerned that then-existing law was itself uncertain because it imposed a "case-by-case" approach as to whether particular prepayments of interest resulted in a "material distortion of income."[42] It is plausible that Congress sought to create a more objective, bright-line test by enacting section 461(g), a goal that is undermined by the more fact-specific approach taken by the Eighth Circuit in *Huntsman.*

In view of its position that refinancing loans of the type involved in *Huntsman* are not within section 461(g)(2), the Internal Revenue Service will not follow that decision outside of the Eighth Circuit.[43] As a practical or planning matter, however, it is unlikely that many taxpayers will purposely avail themselves of the type of short-term financing and refinancing present in *Huntsman.* Unless interest rates are at an historically high level (as was the case in 1981, when the taxpayers in *Huntsman* incurred their initial loan), many borrowers will likely be unwilling to bear the economic risk inherent in a balloon note financing. Moreover, the presence of significant non-deductible transaction costs (*e.g.*, title search and insurance fees, appraisals, counsel fees and other closing costs) in such financings and refinancings would seem to be a further deterrent to deliberately structuring a transaction in this

40. As noted *supra* text accompanying notes 16-17, the committee reports provide that a loan will not qualify under the § 461(g)(2) exception "if the loan proceeds are used for purposes other than purchasing or improving the taxpayer's principal residence, or if loan proceeds secured by property are used to purchase or improve his residence. The exception applies only to points on a home mortgage, and not to other interest costs on such a mortgage."

41. *See infra* note 44.

42. *See supra* text accompanying note 13.

43. Action on Decision CC-1991-02, Feb. 11, 1991, *available in* LEXIS, Fedtax Library, Rels File.

manner.[44]

It is, therefore, probable that courts will limit *Huntsman* to its facts, as the Tax Court has recently done. For example, in *Kelly v. Commissioner*,[45] the taxpayer purchased a home in December 1983 with a thirty-year, variable rate mortgage loan which provided for interest rate readjustments every three years. In June 1986, he refinanced the initial loan with a fifteen-year, fixed rate mortgage, in connection with which he paid and deducted $1250 in points. The Tax Court sustained the Commissioner's disallowance of the deduction. It emphasized that, unlike the initial three-year loan in *Huntsman*, the refinanced loan at issue in *Kelly* was payable over thirty years and was not required to be repaid within a short period of time. Thus, the taxpayer was not required to obtain the later loan. Rather, he had obtained it not to finalize the purchase of a principal residence, but instead to secure a fixed and lower rate of interest. Similarly, in *Dodd v. Commissioner*,[46] the taxpayer paid points in connection with refinancing a mortgage on property that he converted from his principal residence to rental property. The Tax Court distinguished *Huntsman* on the grounds that the refinanced loan at issue constituted long-term, permanent financing rather than a short-term, temporary loan. It further noted that section 461(g)(2) was in any event inapplicable because the property secured by the refinancing loan had ceased to be the taxpayer's principal residence.

3. *Loan Proceeds Used in Connection with the "Improvement" of a Principal Residence and the Related Problems of Refinancing*

The exception provided by section 461(g)(2) also applies to points paid for indebtedness incurred in connection with the improvement of

44. In preparing this article, however, the author has learned that certain lenders presently offer so-called "30 due in 5" or "30 due in 7" loans. These loans provide for monthly payments at a fixed interest rate based upon a thirty-year amortization schedule. However, after five or seven years, respectively, the unpaid principal balance of the loan becomes due. At that time, if certain conditions are met, the lender will extend the loan at an interest rate determined by reference to a certain FHLMC rate for an additional 25- or 23-year term upon the payment of a fee and "related costs." However, the lender is not required to extend the term if the prescribed certain conditions are not met. Similarly, the borrower is free to decide not to extend the loan, and may choose to repay the amount due from the proceeds of another loan. If, during the fifth or seventh years of such loans, as applicable, a taxpayer pays points in either extending such a loan or incurring a new loan with which to repay the outstanding principal amount of the initial loan, there is an argument that those points are deductible under the rationale of the Eighth Circuit's decision in *Huntsman*, since the extension or refinancing or can be seen as having an "association or relation" with the initial loan.

45. 62 T.C.M. (CCH) 1406 (1991).

46. 63 T.C.M. (CCH) 3141 (1992).

a taxpayer's principal residence.[47] Cases and rulings have not generally addressed this aspect of the use of proceeds under section 461(g)(2). The Internal Revenue Service has ruled, however, that where points are paid in connection with a loan that is used partly to refinance an existing purchase money mortgage and partly to improve the taxpayer's principal residence, that portion of the points attributable to the portion of loan used for the improvement of the residence is deductible under section 461(g)(2), even though the remainder of the loan proceeds are used for a non-qualifying purpose.[48]

4. *Disparity between Qualified Residence Interest Defined in Section 163 and Points Qualifying for Deduction under Section 461(g)(2)*

Finally, with regard to the requirement concerning the purpose for which loan proceeds are used, some disparity exists between the terms used in section 461(g)(2) and the definition of deductible "qualified residence interest" under section 163(h). As indicated above, "interest" must be deductible generally under section 163 in order to be both subject to section 461(g)(1) and eligible for the exception of section 461(g)(2).[49] However, because of linguistic differences between the two provisions, the timing of the deduction for prepaid interest or points that constitute "qualified residence interest" under section 163 may still be affected under section 461(g).

First, "qualified residence interest" under section 163 consists of "acquisition indebtedness" and "home equity indebtedness," either of which can include indebtedness secured by a residence other than the taxpayer's principal residence.[50] Under section 461(g)(2), however, points are currently deductible only if they relate to indebtedness secured by and incurred in connection with the purchase or improvement of the taxpayer's *principal* residence. Thus, for example,

47. Here again, the statutory language expressly requires that such indebtedness be secured by the taxpayer's principal residence in order for § 461(g)(2) to apply.
48. In Rev. Rul. 87-22, 1987-1 C.B. 146 (Situation 2) the taxpayer initially obtained a loan exclusively for the purchase of a principal residence. In 1986, she obtained a new $100,000 loan secured by the residence, using $80,000 of the proceeds to retire the outstanding principal balance of the old mortgage loan, and using the remaining proceeds to pay for improvements on her principal residence that cost $20,000. In obtaining the refinancing loan, she paid 3.6 points ($3600). The Internal Revenue Service ruled that 80 percent of the new loan (that portion of the proceeds used to repay the old mortgage) was not incurred in connection with the purchase or improvement of the taxpayer's principal residence and, therefore, points allocable thereto were not deductible under § 461(g)(2). However, the remaining 20 percent of the indebtedness was incurred in connection with the improvement of the principal residence. Therefore, 20 percent of the total points paid (20% of $3600, or $720) were deductible under § 461(g)(2).
49. *See supra* note 24 and accompanying text.
50. *See supra* note 2.

although interest on indebtedness incurred to purchase or substantially improve a second residence (other than the taxpayer's principal residence) is deductible under section 163(h), points paid in connection with such indebtedness are not deductible under section 461(g)(2).

Second, as noted earlier, the definition of "acquisition indebtedness" expressly includes certain indebtedness used to refinance existing indebtedness,[51] whereas authorities construing section 461(g)(2) have generally held that points paid in connection with debt incurred to refinance existing debt are not eligible for deduction under section 461(g)(2).[52]

Finally, the definition of "acquisition indebtedness" under section 163(h) requires that the loan proceeds be used to "acquire, construct, or *substantially* improve a qualified residence of the taxpayer," whereas section 461(g)(2) requires that the indebtedness be used in connection with the "purchase or improvement of . . . the principal residence of the taxpayer." This linguistic difference raises two separate issues. First, it is unclear that section 461(g)(2) is phrased broadly enough to permit a current deduction for points paid in respect of indebtedness incurred to *construct* (as distinguished from *purchase*) a principal residence. Second, if the indebtedness is incurred to substantially improve, and is secured by, the taxpayer's principal residence, points paid in connection therewith will satisfy the requirements for current deductibility under sections 163(h)(3)(B) and 461(g)(2).[53] But, what if the loan proceeds are used to improve, and are secured by, the taxpayer's principal residence, but the particular improvements are not considered "substantial?" Although such debt is not "acquisition indebtedness" under section 163(h)(3), it may qualify as "home equity indebtedness,"[54] subject to the limits set forth in section 163(h)(3)(C). Accordingly, points paid where the loan is used to improve and is secured by the taxpayer's principal residence, but the improvement is not considered "substantial," should nevertheless be eligible for deduction under section 163(h)(3)(C)(as home equity indebtedness) and under section 461(g)(2).[55]

In light of the foregoing discussion, it appears that the disparity

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51. *See supra* note 36.

52. *See supra* text accompanying notes 33-45.

53. *Cf.* Rev. Rul. 87-22, 1987-1 C.B. 146, discussed *supra* note 47, (indicating that where 20% of loan proceeds were used to improve a principal residence, 20% of points paid in obtaining the loan were deductible under I.R.C. § 461(g)(2)).

54. *See supra* note 4.

55. *Cf.* Persellin, et al., *supra* note 37 (suggesting that where indebtedness of over $1 million is incurred in connection with the purchase of a principal residence, points paid in connection therewith are deductible to the extent that they are allocable either to acquisition indebtedness (*i.e.*, the first $1 million of indebtedness) or to home equity indebtedness (*i.e.*, the remaining indebtedness, up to a maximum amount of $100,000)).

between section 163(h) and section 461(g)(2) is both a source of complexity and a potential obstacle to taxpayer compliance in this area. Accordingly, given the current law's relatively limited definition of deductible interest under section 163, it seems appropriate for Congress to consider whether, in the interest of administrability, section 461(g)(2) should be amended to make the category of points deductible thereunder more consistent with the category of interest deductible under section 163(h). If Congress wishes to clarify without substantially altering the law in this area, it could import into section 461(g)(2) the basic idea contained in the definition of "acquisition indebtedness" under section 163(h), insofar as it relates to a taxpayer's principal residence. This could be accomplished by amending section 461(g)(2) to provide, in substance, as follows:

> (2) EXCEPTION — This subsection shall not apply to points paid in respect of any principal residence acquisition indebtedness, to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area. For purposes of this paragraph, the term "principal residence acquisition indebtedness" means any indebtedness which is (a) incurred in [or alternatively, in connection with] acquiring, constructing, or substantially improving a principal residence (within the meaning of section 1034) of the taxpayer and (b) secured by such residence."

Such a revision would not, absent specific references in pertinent legislative history, necessarily resolve the issues raised by the *Huntsman* decision concerning points paid in the context of refinancings. However, it would at least harmonize the language of sections 163(h) and 461(g)(2) and make each provision more consistent with the other. It would also have the further effect of clarifying the immediate deductibility of points paid in connection with indebtedness incurred to construct a principal residence.

D. Timing of Allowance of Deduction for Points not Within Section 461(g)(2)

When an otherwise proper deduction for points is not currently allowable under section 461(g)(2), because, for example, the points were withheld from the loan proceeds advanced by the lender or the loan proceeds were not used for a qualifying purpose specified in section 461(g)(2), a question arises as to when the taxpayer may claim the deduction. Under the law in effect prior to the enactment of section 461(g), such points were treated as having been paid ratably over the life of the loan.[56] That also appears to have been the prevailing prac-

56. Thus, for example, in Cathcart v. Comm'r, 36 T.C.M. (CCH) 1321 (1977), the taxpayers were required to prorate the sum of $1080.60 in points over the entire 29 year period of their loan. They incurred the loan in January 1973 and made 11

tice after the enactment of section 461(g).[57] It is significant, however, that by its terms, the statute provides that "interest paid by the [cash-method] taxpayer that is properly allocable to any period (A) with respect to which the interest represents a charge for the use or forbearance of money and (B) which is after the close of the taxable year in which paid shall be charged to capital account and shall be treated as paid in the period to which so allocable."[58] Thus, a taxpayer who is subject to section 461(g)(1) may not deduct interest paid earlier than the taxable year in which (and to the extent that) the interest represents a charge for the use or forbearance of money. The question of identifying the "proper taxable year with respect to which the interest represents a charge for the use or forbearance of money" has been made somewhat more difficult by the tax law's recent emphasis, particularly since the enactment of the Tax Reform Act of 1984, on time value of money issues and the principles of economic accrual.[59]

This recent emphasis suggests that a ratable allocation of points deferred under section 461(g) might not be permissible because, put simply, that method (*i.e.*, dividing the total amount of interest to be paid over the total period of the loan) does not conform to the principles of economic accrual. However, requiring individuals to use principles of economic accrual could impose upon them a significant degree of complexity that could be avoided by permitting the use of a simple method of ratable accrual. Accordingly, in Revenue Procedure 87-

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monthly payments in that year. The court determined that their ratable share of the deduction for 1973 was $34.34 by using the following formula:

Points paid ($1,086.60) x (# of monthly payments made during year (11)/12 months) x (1/29-year term).

57. See Priv. Ltr. Rul. 86-37-058 (June 12, 1986) wherein the taxpayer paid seven points during 1983 in connection with a 29-year loan for the purchase of a home. Because only three points represented the normal and customary charge in the area, four of the seven points, although actually paid, were ineligible for the § 461(g)(2) exception and therefore subject to the deferral rule of § 461(g). The taxpayer had deducted 1/29th of the amount of these four points ratably on her 1984 and 1985 returns. During 1986, when approximately $3000 of the points remained to be deducted, the taxpayer refinanced the 1983 mortgage. The Internal Revenue Service approved the taxpayer's treatment of the points for 1984 and 1985, indicating that prepaid interest (other than that eligible for the exception under § 461(g)) "is deducted ratably over the life of the loan." Furthermore, it ruled that because the taxpayer repaid the balance of the original 29-year loan in 1986 using the proceeds of the refinancing loan, the $3000 of prepaid interest remaining to be deducted under the original loan should be deducted on her 1986 income tax return.

58. I.R.C. § 461(g)(1)(1988).

59. See Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1 (1986-1987); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986). *Cf.* Prabel v. Comm'r, 91 T.C. 1101 (1988)(deduction of interest computed by using the "Rule of 78's" did not comport with principles of economic accrual and was disallowed).

15,[60] the Internal Revenue Service indicated that, as a matter of administrative convenience, certain taxpayers would be permitted consistently to allocate points ratably over the indebtedness period, rather than be required to use principles of economic accrual. That revenue procedure permits cash-method taxpayers who satisfy specified requirements to use a ratable allocation method where the current deduction of points is disallowed either because the exception provided by section 461(g)(2) is unavailable or because the points were withheld by the lender as part of a net proceeds loan. For the sake of administrative convenience, therefore, the Internal Revenue Service has expressly allowed eligible taxpayers to use a ratable allocation method, notwithstanding that method's divergence from the principles of economic accrual.[61]

IV. REVENUE PROCEDURE 92-12: A SAFE HARBOR FOR DEDUCTING POINTS PAID IN CONNECTION WITH THE ACQUISITION OF A PRINCIPAL RESIDENCE

A. Overview and Requirements of the Safe Harbor

In light of the foregoing, it is appropriate to consider the Internal Revenue Service's most recent pronouncement in this area, Revenue Procedure 92-12. The stated purpose of Revenue Procedure 92-12 is to "minimize possible disputes regarding the deductibility of points paid

60. Rev. Proc. 87-15, 1987-1 C.B. 624.

61. The ratable allocation method endorsed in Rev. Proc. 87-15 applies to a taxpayer who:

(1) Is an individual;

(2) Uses the cash receipts and disbursements method of accounting;

(3) Was charged points in respect of an indebtedness such that:

(A) The indebtedness is secured by a residence (whether or not the residence of the taxpayer);

(B) The term of the indebtedness is no greater than 30 years;

(C) If the term of the indebtedness is greater than 10 years, the provisions of the indebtedness, including the requirements concerning when principal must be repaid, are customary (in the area where the indebtedness was incurred) for loans of the same or longer term financing the purchase of residential real estate; and

(D) Either—

(i) The initial principal amount of the indebtedness was no greater than $250,000; or

(ii) The number of points charged was no greater than—

(a) 4, in the case of indebtedness with a term of 15 years of less;

(b) 6, in the case of indebtedness with a term of over 15 years; and

(4) May deduct the points no sooner than the taxable year to which they are allocable.

Rev. Proc. 87-15, 1987-1, C.B. 624. For a discussion of how, under the principles of economic accrual, points might be treated as accruing like original issue discount under a self-amortizing installment loan, see Lokken, *supra* note 59 at 24, n.42 and 64-66.

in connection with the acquisition of a principal residence."[62] To that end, it creates a safe harbor test which, if satisfied, will ensure that amounts are treated as currently deductible points. Specifically, the Internal Revenue Service will consider amounts paid by a cash method taxpayer to be deductible "points" where all five of the following criteria are satisfied:

— *Designation on Uniform Settlement Statement.* The amount must be designated as "points incurred" in connection with the indebtedness on the Uniform Settlement Statement (*i.e.*, the Form HUD-1) prescribed under the Real Estate Settlement Procedures Act of 1974.[63]

— *Computation as Percentage of Amount Borrowed.* The amount must be computed as a percentage of the stated principal amount of the indebtedness incurred by the taxpayer.

— *Charged Under Established Business Practice.* The amount paid must conform to an established business practice of charging points for loans for the acquisition of personal residences in the area in which the residence is located, and the amount of points paid must not exceed the amount generally charged in that area.

— *Paid for Acquisition of Principal Residence.* The amount must be paid in connection with the acquisition of the taxpayer's principal residence, *and* the loan must be secured by that residence.

— *Paid Directly By Taxpayer.* The amount must be paid directly by the taxpayer. An amount is so paid if the taxpayer provides, from funds that have not been borrowed for this purpose as part of the overall transaction, an amount at least equal to the amount required to be applied as points at the closing. The amount provided may include down payments, escrow deposits, earnest money applied at the closing, and other funds actually paid over at closing.

B. Discussion of the Criteria

The first two requirements of the safe harbor are apparently designed to ensure that the amount deducted as points actually constitutes interest, that is, compensation for the use or forbearance of money. The first requirement, that the amount be designated as points on the Form HUD-1, makes it likely that the lender and the borrower both will treat the points consistently for Federal income tax purposes.[64] No particular language is required in designating the

62. Rev. Proc. 92-12, 1992-3 I.R.B. 27. Rev. Proc. 92-12 was clarified and amended in several respects by Rev. Proc. 92-12A, 1992-26 I.R.B. 20 (June 29, 1992). For a description of the provisions of Rev. Proc. 92-12A, see *infra* notes 65, 69, and 75.

63. *Id.* at § 2.01; The Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601-2617 (1988).

64. In cases in which points are immediately deductible by the borrower under § 461(g)(2), the mortgage lender has gross income upon receipt of the points, whether the lender uses the cash receipts and disbursements method or accrual method of accounting. *See, e.g.*, Bell Federal Sav. and Loan Ass'n v. Comm'r, 62

points as such on the Form HUD-1. Rather, the revenue procedure contemplates that the amount can be designated as "loan origination fees" (including amounts so designated on Veterans Affairs (VA) and Federal Housing Administration (FHA) loans), "loan discount," "discount points" or "points."[65] The second requirement, that the amount designated as points be computed as a percentage of the loan amount, is designed to ensure that the amount of points will be a function of the amount loaned, and therefore constitute interest for tax purposes (that is, a charge for the use or forbearance of money, rather than a charge for services).

The third requirement, that the amounts paid conform to an established business practice in the area and do not exceed amounts generally charged in the area, is derived from the statute itself. There is little prior authority concerning this requirement,[66] and resolution of the issue in any given case apparently depends upon lending practices within the particular geographic region in which the loan transaction occurs. The safe harbor of the revenue procedure uses as the relevant geographic area "the area in which the residence is located," whereas the statute refers to "the area in which the indebtedness is incurred." One anticipates that in many cases these two geographic areas will correspond with one another. Situations could arise, however, in which they do not. In those cases, in order to be within the safe harbor, it must be ascertained that the charging of points is consistent with the business practice in the locality in which the residence is located, and that the amount of points so charged does not exceed the usual and customary amount in that area. Finally, consistent with its aims under the first two requirements, Revenue Procedure 92-12 emphasizes in connection with this third requirement that "if amounts designated as points are paid in lieu of amounts that are originally

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T.C.M. (CCH) 376 (1991)(accrual method taxpayer); Priv. Ltr. Rul. 86-31-007 (Apr. 18, 1986)(cash method taxpayer). *See generally*, Lokken, *supra* note 59 at 24, n.42.

65. Rev. Proc. 92-12, § 1992-3, I.R.B. 27. The reference to loan origination fees on VA and FHA loans was added by Rev. Proc. 92-12A, 1993-26 I.R.B. 20. That latter revenue procedure further added a new section to Rev. Proc. 92-12 to clarify that the safe harbor applies to VA and FHA loan origination fees that meet the requirements of that revenue procedure.

66. In Priv. Ltr. Rul. 86-37-058 (June 12, 1986), the taxpayer purchased a home and paid in the aggregate seven points, whereas payment of only three points was the normal and customary practice in the area. The taxpayer in the ruling had immediately deducted three points and prorated the remaining four points based upon the 29-year life of the loan (*i.e.*, 1/29 per year) through 1986, at which time she refinanced the initial mortgage. The Internal Revenue Service ruled that in 1986, when she refinanced and repaid the initial loan, the taxpayer could deduct that the portion of the four points that remained to be deducted (*i.e.*, 26/29). The ruling assumed as a fact that the four points in question were in excess of the normal and customary charges in the area, and thus did not set forth criteria that would be used for making such a determination. *See supra* note 57.

stated separately on the settlement statement (such as appraisal fees, inspection fees, title fees, attorney fees, property taxes, and mortgage insurance premiums), those amounts are not deductible as points under [the] revenue procedure."

As discussed above, the determination of whether any given taxpayer satisfies the third requirement of the safe harbor test is dependent upon the lending practices in the geographic region in which the residence is located. This fact undermines somewhat the objective guidelines that a safe harbor test is generally intended to provide, since taxpayers will apparently have to independently determine what such practices are. The Internal Revenue Service has not attempted to prescribe set numerical safe harbors within various geographic regions. On this point, the statutory language of section 461(g)(2) provides that section 461(g)(1) will not apply to qualifying points "to the extent that, *under regulations prescribed by the Secretary*, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area."[67] The statute thus seems to have contemplated that regulations would indicate whether and to what extent the payment of points was consistent with prevailing lending practices on an area-by-area basis, but no such regulations have been proposed or issued. Providing such guidance on an area-by-area basis, either through regulations or other, less formal guidance, would facilitate the determination of whether the payment of points by any given taxpayer complies with the third requirement of the safe harbor of Revenue Procedure 92-12.[68]

The fourth requirement indicates that the safe harbor of the revenue procedure applies only to amounts paid in connection with the acquisition of the taxpayer's principal residence and emphasizes that the loan must be secured by that residence. This is not to say that points not meeting these criteria will not be deductible under section 461(g)(2); they may or may not be, depending upon the facts. However, they will not be within the safe harbor of the revenue procedure.[69] Thus, taxpayers seeking to deduct points not within the safe

67. I.R.C. § 461(g)(2)(1988)(emphasis added).

68. Compare in this respect, Rev. Proc. 87-15, discussed *supra* note 61, providing guidelines as to when taxpayers who pay points that are not currently deductible under § 461(g)(2) may use a proration method to deduct the points over the life of the loan, rather than a method that reflects the economic accrual of interest. There, the Service provides guidelines based upon the number of points paid, the maturity of the loan, the amount financed and various other factors. An analogous approach under § 461(g)(2) outlining numerical safe harbors on a region-by-region basis would be of assistance to taxpayers in determining compliance with this third test of Rev. Proc. 92-12.

69. As amended by Rev. Proc. 92-12A, discussed *supra* note 61, Rev. Proc. 92-12 indicates five categories of points to which the safe harbor of the revenue procedure does not apply:

harbor will have to rely upon other authorities, as discussed herein.

Finally, the fifth requirement reiterates that, as illustrated by the authorities discussed earlier, the taxpayer must actually and directly *pay* the points in question in order to deduct them under section 461(g)(2).[70] On this point, it is significant that the revenue procedure indicates that this requirement will be met "if the taxpayer provides, from funds that have not been borrowed for this purpose as part of the overall transaction, an amount at least equal to the amount required to be applied as points at the closing."

The revenue procedure's inclusion of the foregoing language is potentially problematic, since it suggests that the safe harbor is unavailable if a taxpayer pays points by using borrowed funds, even though those funds are borrowed from someone who is not the mortgage

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1. Points paid in connection with the acquisition of a principal residence, to the extent that the points are allocable to an amount of principal in excess of the aggregate amount that may be treated as acquisition indebtedness under § 163(h)(3)(B)(ii)(1988);
2. Points paid for loans the proceeds of which are to be used for the improvement, as opposed to the acquisition, of a principal residence;
3. Points paid for loans to purchase or improve a residence that is not the taxpayer's principal residence, such as a second home, vacation property, investment property, or trade or business property; and
4. Points paid on a refinancing loan, home equity loan, or line of credit, even though the indebtedness is secured by a principal residence.
5. Points paid by the seller of a principal residence to or on behalf of the buyer as part of the overall transaction.

The Service has apparently chosen to exclude these five categories of points from the operation of the safe harbor for a variety of reasons. As this article suggests, the deductibility of points described in the first category would seem dependent upon the specific facts. Although such points will not be considered interest on "acquisition indebtedness," they may, in appropriate cases, be treated as interest on "home equity indebtedness." *See supra* note 55. Points described in the second category are, subject to the qualifications described *supra* text accompanying notes 53-55, generally deductible under § 461(g)(2), although the Internal Revenue Service has not chosen to include them within the safe harbor. *See supra* notes 47-48 and accompanying text. Points described in the third category are clearly ineligible for the § 461(g)(2) exception. The deductibility of points described in the fourth category is particularly dependent upon the use to which the loan proceeds are put and, thus, not generally susceptible of a safe harbor test. *Cf.* Rev. Rul. 87-22, discussed *supra* note 53 (holding 20% of points deductible under § 461(g)(2) where 20% of loan proceeds are used for improvement of principal residence). Furthermore, the Service has generally taken the position that points paid in connection with indebtedness that is incurred to refinance other indebtedness is not eligible for deduction under § 461(g)(2). *See supra* notes 33-45 and accompanying text. Finally, the Service has apparently chosen to exclude points in the fifth category, added by Rev. Proc. 92-12A, in order to enforce the requirement of the safe harbor, discussed *infra* text accompanying note 70, that the taxpayer directly pay the amounts to be treated as points. For further discussion of this fifth category of exclusion from the safe harbor, see *infra* note 75.

70. *See supra* text accompanying notes 27-31. *See also infra* note 75.

lender (from a parent, for example). The cases and authorities discussed herein indicate that the Internal Revenue Service's principal concern in this context is the situation in which the points are withheld by the *lender* as part of a net proceeds loan.[71] Furthermore, regarding the deductibility of interest generally, the Internal Revenue Service has taken the view that a cash method taxpayer will not be considered to have "paid" interest on an outstanding loan where payment is made with funds themselves borrowed for that purpose from the same lender to whom the interest payment is owed.[72] However, where such an arrangement is not present, and actual payment is made, a deduction should be allowable even if the payment was made out of funds that were themselves borrowed, so long as the mortgage lender was not the source of those funds.[73] On this subject, it should be noted that the revenue procedure does not provide categorically that the funds used to pay points may not be "borrowed," but rather that they "may not be borrowed for this purpose as part of the overall transaction." This language might be interpreted to mean that the safe harbor is available so long as the funds were not borrowed as part of the overall transaction or course of dealing between the taxpayer

71. *See supra* text accompanying notes 27-31.

72. For a cash method taxpayer, the giving of the taxpayer's own promissory note does not constitute payment, although the remittance of money borrowed from a third party does. *See* Don E. Williams Co. v. Comm'r, 429 U.S. 569 (1977). Applying this rationale, there is some question in the cases as to whether a cash method borrower will be considered to have "paid" interest on an outstanding loan where payment is made with funds themselves borrowed from the same lender. *Compare* Burck v. Comm'r, 63 T.C. 556 (1975), *aff'd on other grounds*, 533 F.2d 768 (2d Cir. 1976)(allowing a deduction so long as borrower had "unrestricted use of the funds," as where they are placed in and commingled with an account not maintained with the original lender) with Battelstein v. Internal Revenue Service, 631 F.2d 1182 (5th Cir. 1980)(en banc), *cert. denied*, 451 U.S. 938 (1981) and Wilkerson v. Comm'r, 655 F.2d 980 (9th Cir. 1981)(applying a "purpose" test, and disallowing a deduction where a cash method taxpayer borrows money from a lender for the express purpose of satisfying an interest obligation owed to that same lender). The Internal Revenue Service has indicated that it will follow the approach of the *Battelstein* and *Wilkerson* decisions. *See* Announcement 83-138 (Aug. 8, 1983) *contained in* 1983-32 I.R.B. 30.

73. Although, as noted *supra* note 72, some courts have held that a deduction is not allowed where interest on one loan is paid with funds borrowed from the same lender, the cases nevertheless agree that a deduction is proper where the interest is paid with the proceeds of a separate loan from a third party. *See e.g.*, Battelstein v. Internal Revenue Service, 631 F.2d 1182, 1185, n.3 (5th Cir. 1980)(en banc), *cert. denied*, 451 U.S. 938 (1981)(acknowledging "the well-established rule that where a taxpayer borrows money from a third party to pay interest due his original lender, the interest is considered paid and deductible") and Wilkerson v. Comm'r, 655 F.2d 980, 983 (9th Cir. 1981)(similarly distinguishing case before it from "those situations in which a separate loan from a third party is used to pay interest"), each *citing* McAdams v. Comm'r, 15 T.C. 231 (1950), *aff'd*, 198 F.2d 54 (5th Cir. 1952) and Crain v. Comm'r, 75 F.2d 962 (8th Cir. 1935).

and mortgage lender.[74] Accordingly, it is to be hoped that the safe harbor of the revenue procedure will be available so long as the points are paid out of funds that are not borrowed from the mortgage lender. In any case, cautious taxpayers will probably wish to pay points out of funds not borrowed from any source, in order to ensure that they squarely comply with this aspect of the safe harbor.[75]

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74. A further argument in favor of so construing this aspect of Rev. Proc. 92-12 is found in Rev. Proc. 92-11 1992-3 I.R.B. 26 (Jan. 20, 1992), issued concurrently with Rev. Proc. 92-12. Rev. Proc. 92-11 deals with information reporting requirements imposed by I.R.C. § 6050H upon recipients of points paid in connection with the financing of a purchase of a principal residence and creates a safe harbor for the information reporting of such points. Specifically, it provides that an interest recipient may report as points under I.R.C. § 6050H(b)(2)(C) any amount that satisfies each of the safe harbor requirements of Rev. Proc. 92-12, including the requirement that the points be "paid directly by the borrower." Rev. Proc. 92-11 indicates that, at least for purposes of this information reporting safe harbor, this latter requirement "will be treated as satisfied if the amount to be treated as paid directly by the borrower was not loaned for this purpose *by an interest recipient* as part of the overall transaction." [Emphasis added]. Thus, although it only purports to address the information reporting safe harbor created by Rev. Proc. 92-11, this language strongly suggests that the requirement in Rev. Proc. 92-12 that the points be paid directly by the borrower should be treated as satisfied where the funds used for such payment were not borrowed from the mortgage lender itself.

   Rev. Proc. 92-11 further provides that a lender of record may enter into a designation agreement with another person, such as a mortgage broker, which transfers to the designee the responsibility for making the information return required by I.R.C. § 6050H concerning points. In order for the designee to rely upon the information reporting safe harbor of Rev. Proc. 92-11, however, the "designation agreement must contain the designator's [*i.e.*, lender's] representation that it did not lend the amount to be treated as paid directly by the borrower for this purpose as part of the overall transaction." Again, this language supports the argument that a borrower will be treated as having paid the points directly where the funds used to do so were not borrowed from the mortgage lender itself.

75. As indicated *supra* note 69, Rev. Proc. 92-12A specifies that the safe harbor of Rev. Proc. 92-12 will also not apply to any "[p]oints paid by the seller of a principal residence on behalf of the buyer as part of the overall transaction." This exclusion is apparently intended to ensure compliance with the requirement under the safe harbor that points be paid directly by the taxpayer. Thus, cautious taxpayers will also want to arrange to pay points directly to the lender, rather than enter into an arrangement under which the seller of property agrees to pay all or part of the points.

   Absent a special rule, rigid application of the foregoing limitation could make the protections of the safe harbor wholly or partly unavailable whenever, as is not uncommon, a seller pays some portion of the buyer's closing costs. For example, assume that a buyer of a principal residence will be required to pay closing costs of $4000, of which $1000 consists of points, and the seller agrees to pay $800 of the buyer's closing costs, with the buyer paying the remaining $3200. One possible approach would be to allocate any costs paid by the seller first to points to the extent thereof, then to any remaining costs. Under such an approach, since the seller paid only $800 and points constituted $1000, the full $800 paid by the seller would be allocable to points, and thus render that amount of the total points paid (*i.e.*, $800 of $1000) ineligible for deduction under the safe harbor of

V. CONCLUSION

Although Congress has permitted individual taxpayers to deduct "qualified residence interest," it has also continued to limit their ability to deduct prepaid interest, or "points" under section 461(g). As indicated herein, points withheld by a lender as part of a net-proceeds loan remain non-deductible by a cash method taxpayer and must be deducted over the term of the loan. With the narrow exception of the Eighth Circuit's decision in *Huntsman*, points paid in connection with refinancings are not currently deductible, except to the extent that a portion of the refinancing loan proceeds are used for the improvement of a principal residence. Similarly, points that satisfy the definition of "qualified residence interest" under section 163 are not, as such, automatically deductible under section 461(g)(2). Points paid in connection with the purchase or acquisition of a second residence provide an example of such a situation. As this Article has suggested, greater coordination between sections 163(h) and 461(g) would alleviate some of the confusion in this area.

The Internal Revenue Service is to be commended for its recent delineation in Revenue Procedure 92-12 of an administrative safe harbor for the deduction of points paid in connection with the purchase of a principal residence. The revenue procedure conveniently states, in a single pronouncement, the Internal Revenue Service's position concerning this issue. Moreover, that position is largely consistent with prior authorities discussed herein. Nevertheless, application of the requirements of the revenue procedure may, in at least two respects, require a more fact-specific inquiry than first appears, thus undermining somewhat the certainty that a safe harbor test is generally intended to provide.

First, the revenue procedure seeks to implement section 461(g)(2), by requiring that the charging of points conform to an established business practice for loans for the acquisition of personal residences in

Rev. Proc. 92-12. Alternatively, a pro-rata approach could be applied; under such an approach, since 1000/4000 or 1/4 of the total closing costs consisted of points, 1/4 of the $800, or $600 paid by the seller would be treated as a payment of points, hence making that portion of the points paid ($600 of the full $1000) ineligible for the safe harbor. Significantly, however, the rule actually decided upon by the Service seems to maximize the likelihood that the safe harbor will be available. Specifically, as amended by Rev. Proc. 92-12A, Rev. Proc. 92-12 provides that if the seller pays any amount to or on behalf of the buyer, and the buyer and seller do not explicitly allocate the amount to points, the amount is allocated, to the extent possible, to expenditures other than points. Thus, on the facts described above, where closing costs other than points exceeded $800, no part of the $800 paid by the seller would be allocated to points absent an explicit agreement to that effect by the buyer and the seller. Therefore, the full $1000 of points will be treated as having been paid by the buyer and thus be eligible for deduction under the safe harbor.

the area in which the residence is located, and that the amount of points paid not exceed the amount generally charged in that area in comparable transactions. By its nature, this inquiry is fact-specific and requires a determination of the prevailing lending practices within a particular geographic region. The Service or the Treasury should consider providing more objective criteria concerning this aspect of the safe harbor test, either through regulations or less formal pronouncements.

Second, the revenue procedure contains a further degree of ambiguity and uncertainty that is inconsistent with the notion of a "safe harbor" by providing that the points be paid "from funds not borrowed for this purpose as part of the overall transaction" may add a further degree of ambiguity and uncertainty that is inconsistent with the notion of a "safe harbor." While this language may be intended to reflect the case law holdings concerning the nondeductibility of points withheld by a lender as part of a net proceeds loan, or the Internal Revenue Service's position that a cash method taxpayer has not "paid" interest where the funds are borrowed from the same lender for this purpose, it arguably is more restrictive than the case law. It could preclude a taxpayer from relying upon the safe harbor if points are paid with funds borrowed from any source, even from a person other than the mortgage lender. It further raises the question of what construction should be given to the phrase "part of the overall transaction." This Article has argued in favor of a limited construction of that phrase.

Finally, it should be recalled that Revenue Procedure 92-12 does not purport to define a comprehensive, all-encompassing test. It addresses only the deductibility of points paid in connection with the acquisition of a principal residence. Points not paid in that connection may or may not be deductible under section 461(g)(2). This Article has also described the Federal income tax treatment of points that are not within the safe harbor.